

MANAGER INSIGHTS

Hard to See a Chinese Hard Landing.

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Overview

- China’s real estate market has corrected recently along with industrial metals prices, which has increased investors anxiety of a significant economic slowdown
- China’s economic growth is in fact slowing, and economic transition issues are complex and challenging, but media-fuelled fears of an imminent, so-called “hard landing” are exaggerated
- Seen through western binoculars, investors run the risk of over-emphasizing the negative and missing the increasing importance of the Chinese economy, which we believe is grossly underrepresented in most investors’ portfolios

Introduction

This question related to a hard landing in China has proliferated through the financial media in recent weeks, as one analyst or talking-head after another turns negative on China’s economy. Price action in equities heavily geared to Chinese economic growth is certainly indicating that all is not well. However, on a daily basis we encounter many examples of confusion, misinformation and misplaced concern about the Chinese economy.

We do believe there are valid and specific concerns that warrant watching, and a general posture of caution is prudent at this stage in China’s economic cycle. We are monitoring several signs of weakness in China’s vast economy, such as government stimulus-driven overbuilding, unregulated and usurious lending, and overextended property developers with liquidity issues. But, we believe that the rumors of China’s economic death are greatly exaggerated. There are tensions in an economy that is still in fundamental transition. But our main focus is not on the rough spots China’s economy faces, which we believe are temporary. Rather, we are focusing on the long-term trends of rising incomes and an emerging middle-class – the forces that will drive economic output and domestic consumption for decades.

Our Bottom Line Forecast

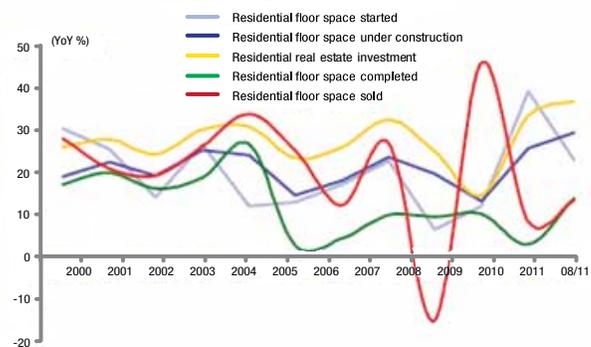
Our view is that China’s economy will not collapse, and its GDP still has the potential to grow at greater than 8% this year, and probably next. Our assumption is that the European experiment does not descend into chaotic dissolution. In that case, growth could well be lower, but in that event, China would likely be among the least of many global problems. Over the medium term, 3-5 years out, we think China’s GDP growth is likely to naturally decline to a more sustainable 5-7%.

Turning to specific issues, we will preface our comments with a couple of observations. First, in a country as big and diverse as China, you can usually find evidence for any trend that you are pre-disposed to believe. Second, in the current risk adverse economic climate, it is especially easy to scare people, and it is always difficult to disprove a negative scenario.

Property and Housing

Front and center in the popular concerns about China’s economic state of affairs is the real estate sector. It is absolutely the case that there has been frenetic building activity in many places in China and the tales of “empty cities” have some (limited) validity (see Chart 1, below). For more than a year, the Chinese government has been acting to restrain property price appreciation, including regulations to prevent excessive speculation by purchasers and developers. Nevertheless, property prices in many places have been edging up or holding at least stable. Although sales activity is slowing down, this is generally what the authorities want. Undoubtedly, there are pockets of weakness in which overleveraged developers are slashing prices to clear inventory, but it’s important not to extrapolate the experience of, say Miami, to China.

CHART 1: RESIDENTIAL HOUSING GROWTH IN CHINA



Source: CLSA

For instance, investors in property in China generally must pay at least 40% of market value in cash, and the average deposit is much higher. About 90% of residential sales are for owner-occupiers, and probably more than half of investors (non owner-occupiers) pay 100% in cash. Some other pertinent differences include the following:

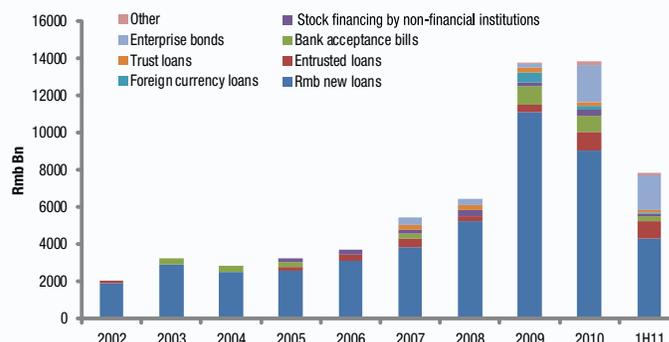
- When mortgages are used in China, they are largely simple fixed-rate loans with maturities averaging about 15 years. Home equity loans (second mortgages) are rare.
- Sustained demand for housing is being driven by powerful trends including urbanization, demographics and replacement of low-quality Communist-era housing.
- The cost of carry for housing in China is relatively low because there the property tax burden is low or non-existent.
- There is a lack of alternative investment opportunities in China. For example, the A-share (domestic) stock market is widely regarded by the Chinese people as little more than a casino. Bank deposits currently yield Chinese savers negative real interest rates. For the Chinese, therefore, home ownership remains an attractive store of value.

Taking a step back, we think that overall, China still faces a significant housing shortage, particularly within the “affordable” housing stock. Indeed, the government has an ambitious target of constructing social housing (e.g., low-income rental) that is sorely needed and has been neglected until recently. This massive construction effort could go a long way to offset a slowdown in the higher-end private sector in terms of demand for steel, cement, etc. We do expect that the slowdown trend among private, higher-end residential starts will continue as developers face tighter liquidity. However, this picture is not adequately represented by photographs of Chinese ghost cities, many of which were ill-conceived, centrally planned projects. We don't believe they represent the bigger picture of Chinese residential development. Also, remember that a slowdown in the pace of building is a welcome development from the authorities' perspective. If they feel the situation is becoming significantly worrisome, we believe policy can easily and quickly be relaxed, as occurred in 2009.

Shadow Banking

We should be careful what we mean by the mildly pejorative term “shadow banking.” Broadly speaking, “shadow banking” is non-bank lending falling outside the scrutiny of government rules and regulations. In China, however, all banks and non-bank lending institutions (except informal lending) are effectively controlled by the government. Non-bank lending has rapidly increased in China (*see Chart 2, above*), and although data can be a little elusive, it would appear that by far the larger part of this is effected through entities such as trust companies that are reasonably well monitored. By this definition, of course, developed countries have large “shadow banking” liabilities. For instance it has been estimated that in March of 2008, the United States had a \$20 trillion shadow banking system – a scale similar to the traditional, regulated banking system. In China, the shadow banking system is far smaller, and perhaps more importantly these institutions are only rarely allowed to significantly leverage their balance sheets.

CHART 2: NEW AGGREGATE FINANCE IN CHINA



Source: CLSA

Of course, China also has an informal lending market that is certainly not fully captured in the official statistics. Informal (or *kerb*) lending has a long history in China, and it is a small part of the overall lending market – perhaps accounting for 5-7% of small- and medium-sized enterprise (SME) capital. Generally, this lending is done through small-scale, short-term collateralized loans between participants who are well known to each other.

Undoubtedly, China's formal banking sector must do a better job of lending to SMEs, and this is a government focus. However, most banks still lack the loan underwriting and risk management resources to properly evaluate small business borrowers. They are not helped by China's labyrinth of laws, property title rules, and lack of clear procedures for collateralization and asset seizures.

These issues are slowly improving, and in the meantime informal lending sectors will continue to fill economic growth and capital-supply needs. China's policy makers understand that, in contrast to most developed markets, net job creation in China has come overwhelmingly from the private sector, and that the private sector still has limited access to formal credit. We do not foresee a “crackdown” on shadow bank lending, but we can anticipate that there will be some stress (and tales of fleeing entrepreneurs) as GDP growth cools. Interestingly, in conversations with small business owners, access to credit, while important, does not appear to be the most pressing business worry. For outward-facing, export-oriented companies, the upward movement in the renminbi is a big issue. Demand is sluggish from Europe and the United States. Costs are rising, often for raw materials, but certainly for labor. As many smaller-sized businesses scale up and adopt increased automation, proper access to capital will be crucial.

Inflation and Interest Rates

China's inflation rate has been running at a pace in excess of government targets for most of 2011, causing the central bank to raise the cost of credit and restrict access to credit, through smaller quotas. There are underlying issues but much of the inflationary pressure is driven by food, as the prices of pork and vegetables have risen. As we roll over into a more benign base effect and with the help of a slowdown in economic growth, we think the inflation problem will substantially moderate through the end of the year.

Local Government Debt

In our opinion, the media's focus on local government debt is misleading. In essence, it means the Communist Party is lending through its own party-controlled banks to the party's local affiliates. Issues of default are very rare – not because all the loans are backed by cash flow or are sensibly invested, but simply because, at the end of the day, it's all back-stopped by the Communist Party. Put simply, transfers that would be deemed fiscal in other countries – e.g., national tax receipts distributed to local governments – are instead funded through a government-controlled lending and banking system in China.

Can the Party afford to finance all of its investments? We think so, because the fiscal deficit should be about 2-3% of GDP and fiscal receipts are up 30% year-over-year.

Chinese Companies Listed in the U.S.

A number of China "bears" have been very vocal about the quality of Chinese companies that are listed on U.S. exchanges, often through the "back door" of shell-company reverse mergers. Chinese companies have historically listed in the U.S. for two principal reasons: 1) They operate in sectors, such as tech, that are better known to U.S. investors; or 2) They are simply bad companies that wouldn't pass the listing criteria in Asia, but can slide into public markets through U.S. reverse mergers, which are not subject to the due diligence scrutiny of an IPO. Reverse merger companies have never been of serious interest to us or most other prudent analysts and investors. Our view is that these companies are often gaming the system to make insiders wealthy, and should be considered irrelevant as barometers of economic vitality.

On the other hand, we do think several sound U.S.-listed Chinese internet companies currently represent attractive values, because they have been sold down due to association with the reverse merger crowd. Bouts of ill-informed retail (and some institutional) selling have created very interesting investment opportunities.

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The demand outlook for well managed Chinese internet and technology companies is obviously substantial. The trick is to separate out the serious companies from some of the rubbish that populates the blogosphere. One issue that does need to be addressed is the Variable Interest Entity (VIE) structure that exists in a number of companies. In China, foreign shareholders are prevented from doing certain types of business, including many related to the internet. To circumvent this rule, foreigners traditionally have deployed VIE structures, in which the license is owned by a local entity but the whole economic interest is owned by the listed company. We strongly believe that existing VIEs involving listed companies are effectively sanctioned by the Chinese government. Undoubtedly, the process for approval of further VIE structures has slowed down with more regulatory scrutiny, but crucially, we don't believe existing VIEs face any serious threat.

Summary

The media headlines and imagery is painting pictures of a Chinese economy that has run aground – and is even falling apart. We would urge doubters to get on a plane to China and investigate the reality themselves. We have been analyzing and commenting on China for over two decades, and based on our experience and first-hand knowledge we believe the "fear" is often grossly exaggerated.

From the depths of post-Civil War reconstruction to the economic heights of the 1960s, it took the U.S. economy a full century to develop its economic potential. China's economic journey is much faster, and it is not without flaws. The adjustments are bound to engender dislocations. But investors who get carried away with negative hype run the risk of missing out on one of the most opportune investment stories of our time.